Moscow Financial Weekly

For the week ending May 17, 2002
Treasury Attache's office, US Embassy Moscow

Highlights

- Agreement on SME tax bill
- CBR agrees to 99.98% sale of Vneshtorgbank to the government
- Law on the Central Bank -- second reading

Weekly focus: CBR as the Good Guys

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R31.2553	0.14	3.71
Monetary Base*	R739.3 bln	-1.32	8.91**
CPI	NA	NA	6.6
International Reserves*	$38.4 bln	0.79	5.20
RTS Index (end of week)	419.73	10.05	63.47
Refinancing rate	23	0	4

*For week prior
** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

Foreign direct investment was $830 million in the first quarter of 2002, almost 14% less than the same period last year. FDI has not kept pace with increased portfolio investment or trade credits, nor does it show any lagged improvement with enactment of major reforms from last year, including judicial, deregulation, and tax. This indicates that strategic investors are still waiting to see how reforms will be implemented in practice before initiating new investments.

In a meeting on May 20, President Putin and Duma leaders reached apparent agreement on amendments to the new **SME tax initiative**. The revenue requirement for companies to qualify for simplified SME taxation were raised to R15 million (or approximately $500,000) as opposed the original GOR proposal of R10 million (or $320,000). The requirement for 20 or less employees was completely dropped. While this does not go as far as Duma deputies wanted, it may help limit the urge for large companies to split into small companies to get the reduced tax benefits. In addition, the tax rate for the option to pay on revenues (designed to be a temporary measure) was reduced from 8 percent to 6 percent, and the option to pay on net profits will be reduced from 20 percent to 15 percent. In terms of social taxes, at least half of the tax will be targeted for the Pension Fund, but SMEs would be relieved of paying the unified social tax. The law should be passed by the Duma before the summer recess. One remaining question, however, will come with implementation. Regions still have the authority to levy imputed taxes on revenue, and if they continue to do so, the simplification and lower rates that would come from the federal proposal would be mitigated.

Cash payments in Russian industry by domestic customers, a yard-stick for the barter economy, reached 79% in March, Goskomstat reported. This compares with 68% one year ago, indicating improvement in the monetization of the Russian economy.

The government signed a decree on May 22 which authorizes Ministry of Finance to **manage state debts** using a special reserve fund for this purpose. The decree provides MinFin the ability to invest the reserve fund in Russian government securities as well at foreign state instruments that have the best international ratings. The government expects corresponding amendments to the Budget Code will be ready for Duma consideration in July. This decree will make it easier for MinFin to buy back debt (it has been doing so anyway but through no transparent means) and will help to wall off surplus revenues from the Duma. Meanwhile discussions continue on the possibility of a formal stabilization fund.

Banking sector

Annual Vneshtorgbank (VTB) shareholders meeting approved VTB annual report, its balance as of January 1, 2002 and the report on profits/losses. It was decided to allocate R631.255 million (26.9% of the 2001 net profits) to pay dividends. The meeting also elected a new supervisory board of the bank consisting of 9 members and chaired by the CBR Chairman Sergey Ignatiev.

According to Yuri Ponomarev, VTB President, the bank expects to receive a syndicated loan from EBRD worth $100-150 million by this fall. This loan would be used to expand lending to the real sector, Ponomarev said.

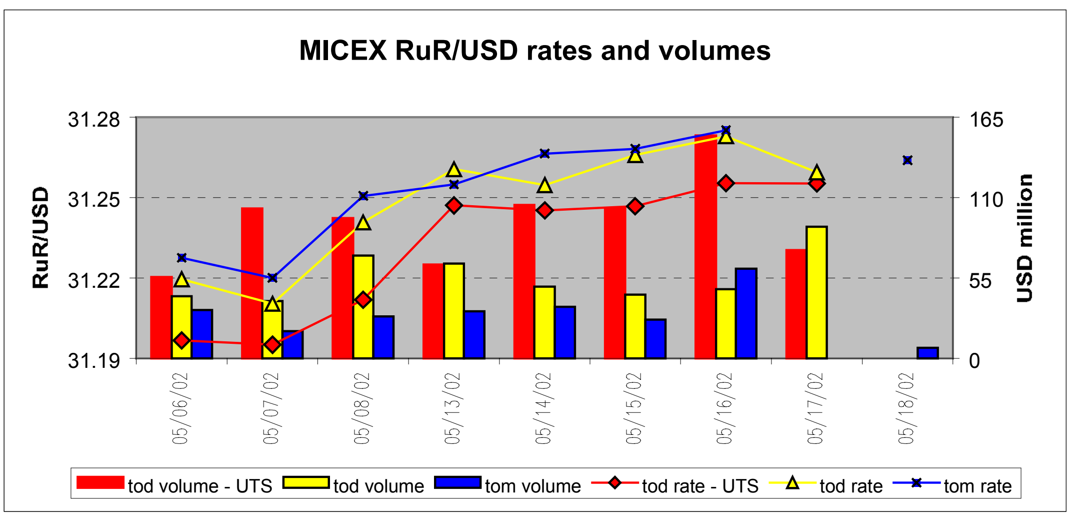
The CBR plans to transfer its shares in VTB to the GOR this fall, Sergey Ignatiev said. This would be the first stage in divestiture, at the second foreign investors would buy stakes in the bank. According to Ignatiev, the law and supporting regulations regarding the divestiture procedures are currently being drafted. In particular, the law will determine how the GOR will pay for the stake. Most likely it will be done with government bonds. Terms and interest rates are being discussed in Minfin now. "The sooner the stake is passed to the GOR, the better," Ignatiev stressed, "but then the GOR must remain a shareholder for at least few years."

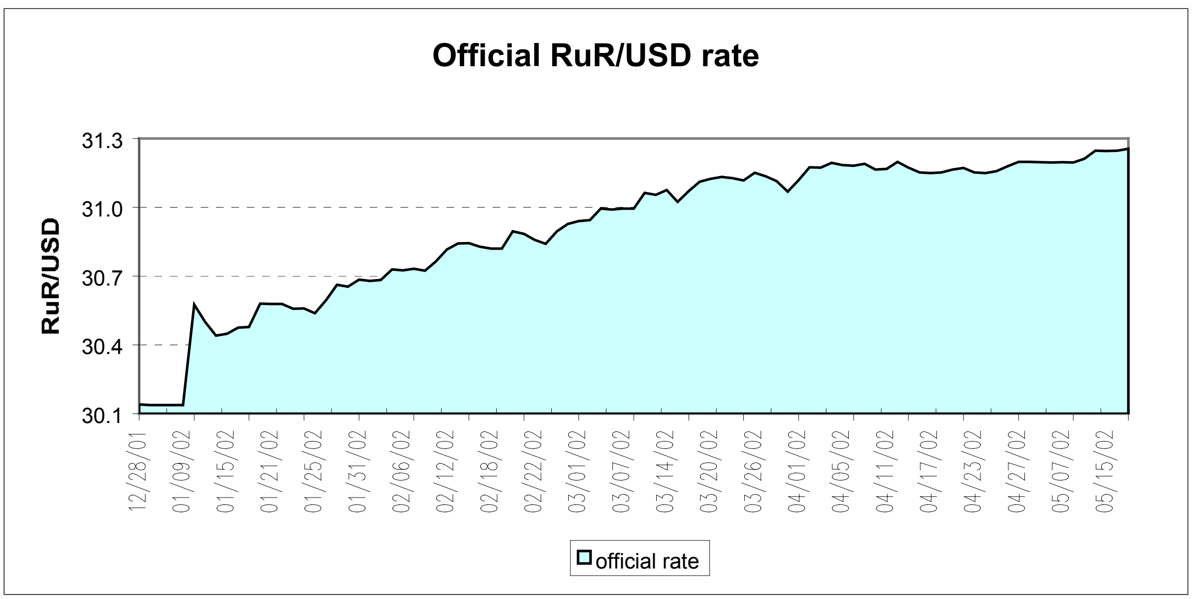
On May 22 the State Duma for the second time (!) passed in the second reading the Law on the Bank of Russia. However, this time Duma deputies agreed to accommodate only the GOR's requirement to reduce the number of National Banking Council (NBC) members from 13 to 12: the President of the RF, the GOR and the State Duma will have 3 representatives each, the Federation Council will be represented by 2 members plus the CBR Chairman will chair the Council. Deputies again voted to limit the number of checks done in a credit institution on the same issue within a year to one. The GOR considers it crucial not to have any limitations on the number (to comply with the Basel principles of effective banking supervision) or, at least, to allow for 2 checks within a period. Deputy Prime Minister Kudrin even threatened that the bill if passed with this provision would be vetoed by the President, but in vain. Deputies also reserved the authority to determine CBR bookkeeping rules for the NBC (instead of the CBR Board) as well as kept the provision allowing the Duma to initiate inspections of CBR's financial activities to be performed by the Accounting Chamber. According to Alexander Shokhin, the author of the bill, now chances that it will be vetoed by President Putin are 50:50.

Financial markets

Forex Market

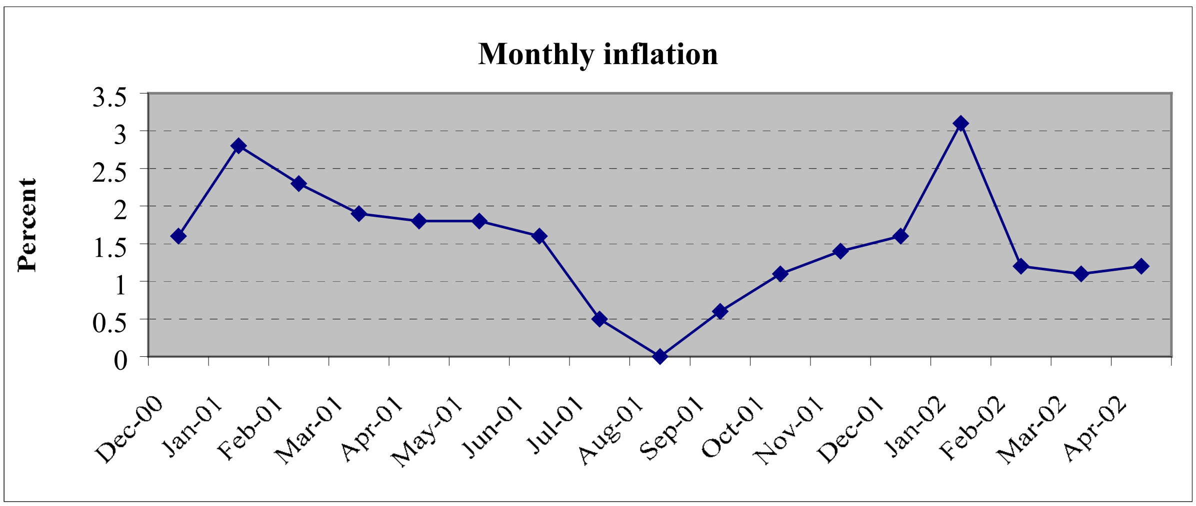
The exchange rate as well as the forex market as a whole has been unusually stable since the beginning of April. With the influx of exporters' dollars due to high oil prices the CBR has to intervene regularly in the MICEX UTS in support of the dollar, not the ruble as was the case in the past. By buying up dollars, up to $200 million a day, the CBR maintained gradual ruble depreciation against the dollar of less than 4 kopeks or just 0.12% in the period from April 1 through May 8. However, on May 13, the first working day after a holiday weekend, the ruble weakened by almost the same 4 kopeks. It stabilized again after that, such that for the week it weakened 0.14%, closing in the UTS on Friday at 31.2553/$. MICEX weekly trade volumes were $498.59 million, $295.03 million and $162.86 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





<u>Prices</u>

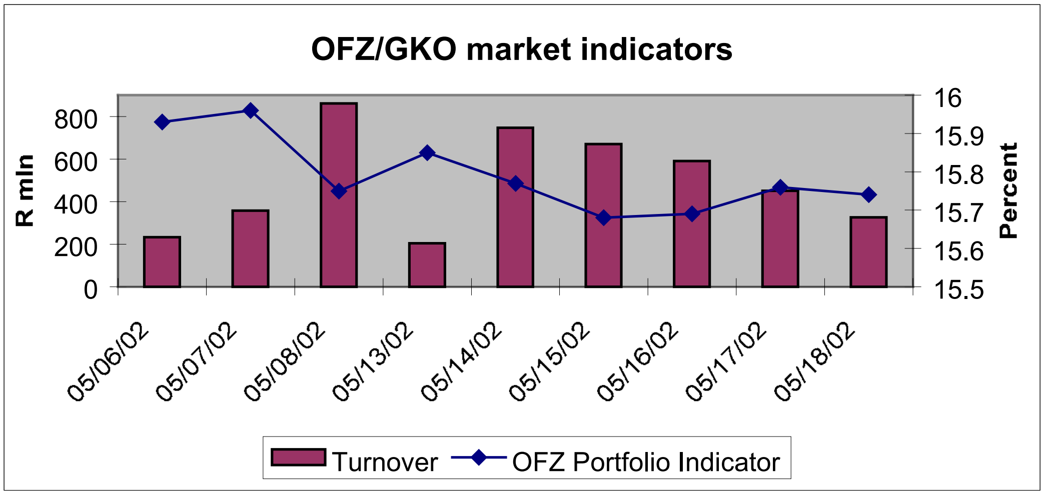
Consumer prices rose 0.5% in the period May 1 - May 13. Average price increase in the first 13 days of May was 0.041% compared with 0.038% in the first 13 days of April. In the first 4 months of this year consumer prices went up 6.6% compared with 9.0% in the first 4 months of 2001. Barring any unforeseen factors, inflation for May will likely be around 1%, the monthly rate seen since February. The monthly rates since February may be artificially low, but averaging the spike of 3.1% in January over the rest of the first half of 2002 should result in a 7-8% rate that is broadly in line with GOR and IFI projections. Inflation in the second half of 2002 could be negatively affected by passage of additional amendments to the 2002 budget, new monopoly tariff increases, and the pressure on CBR reserves with sustained higher than expected oil prices.



Interest/Bond Market

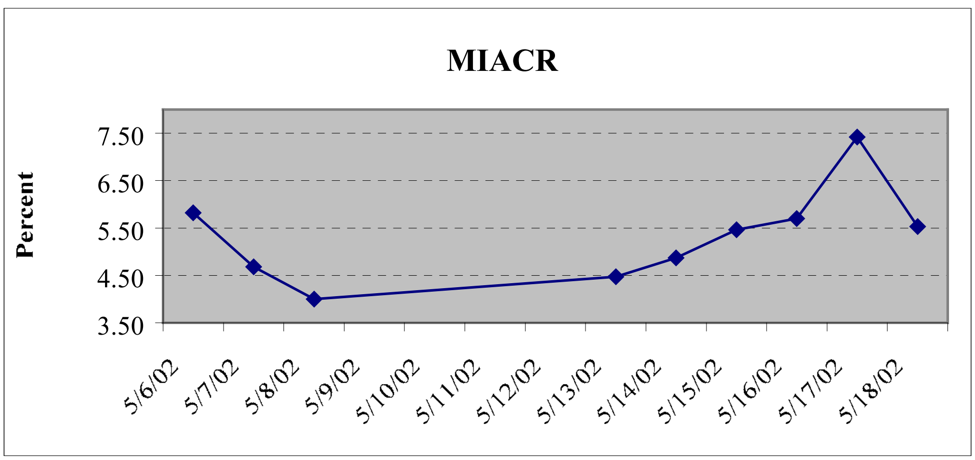
Bonds/Bills

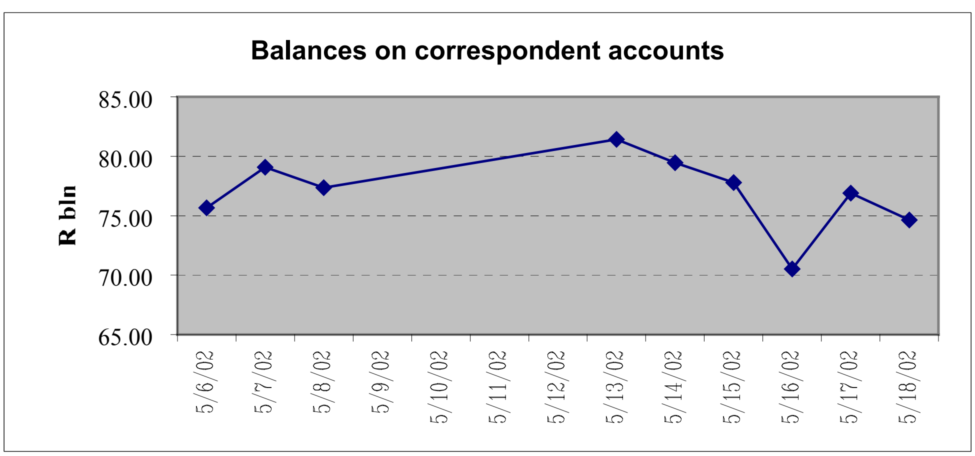
Markets were flat in the days before the auction of R5 billion of 6 month GKOs and R10 billion of a new amortizing OFZ issue on Wednesday May 22. The Ministry also redeemed approximately R11 billion of a maturing OFZ issue on the same day. The principal of the amortizing OFZ issue will be redeemed in four quarterly installments over 2005-2006. Despite high demand, MinFin only sold R2 billion of each issue at yields previously announced (17.41% for OFZ and 14.4% for GKOs). The long-term duration of this issue will help develop domestic debt markets and should be attractive to institutional investors and the pension fund. However, liquidity of markets will ultimately depend on the yields offered.



Overnight rates

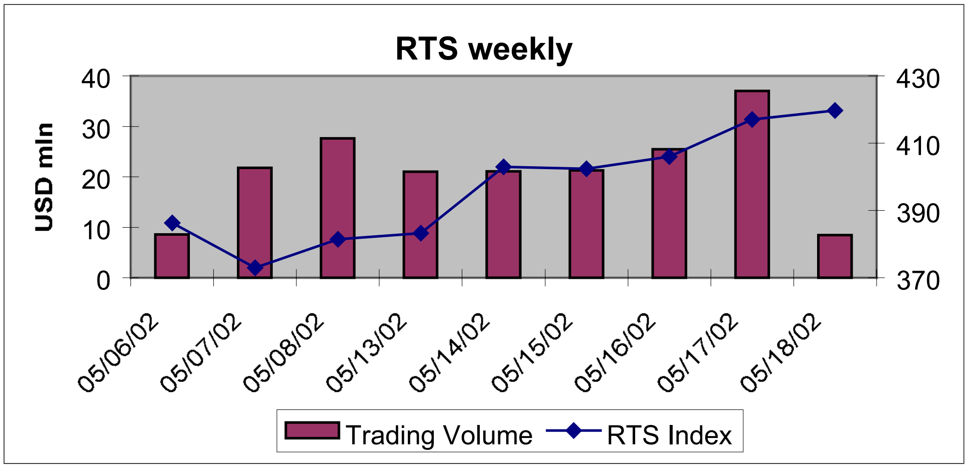
Overnight ruble loan rates were relatively stable with a local peak at 7.42% on May 17.





Stock Market

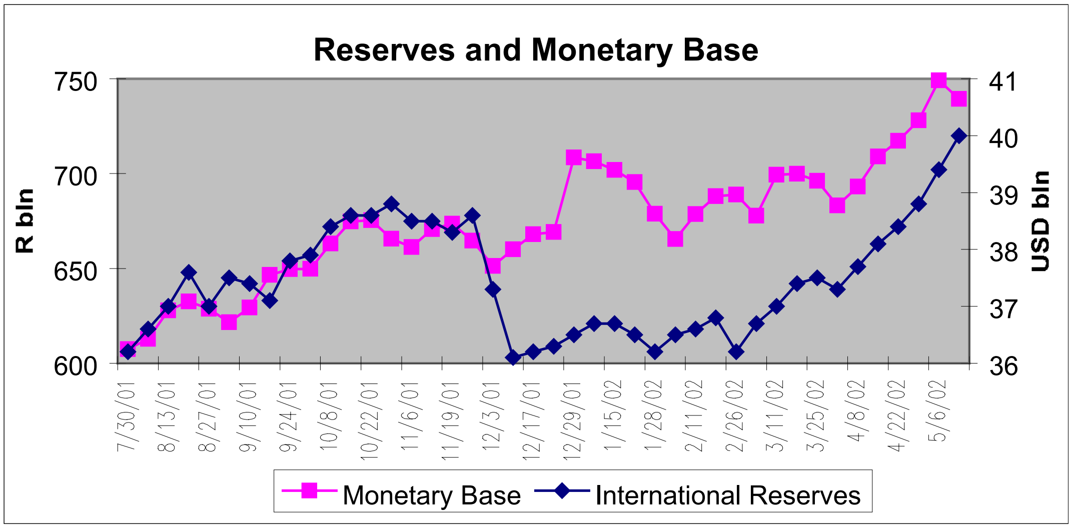
The RTS ended last week on a high note, having reached a record high of 420 on the back of favorable foreign events (continued recovery in the US, conclusion of an arms reduction deal, and the upcoming Putin-Bush summit). However, the first two days of the following week the market was slightly lower or flat, in the absence of significant domestic or international news.



International Reserves and Monetary Base

International reserves have been growing steadily since the beginning of April to reach, as of May 16, a new record high of $40 billion. At the EBRD annual meeting in Bucharest, Deptuy Finance Minister Kolotukhin said in a speech that the government expects to see only small increase in reserves from this level by end of year. However, if the oil price continues to hold above $20 per barrel and the CBR continues to require currency conversion of 50% of export earnings, the only way to hold reserves down without causing real appreciation in the ruble would be to continue the policy of prepayment of external debt, which the government has already indicated it plans to do.

The monetary base, on the other hand, fluctuated during this period, shrinking between May 6 and May 13 from R749.2 billion to R739.3 billion.



Weekly Focus: Getting Used to CBR as the Good Guys

Bank reform seems poised to take off. OK, we said the same thing almost a year ago, but this time we really mean it. Last June and July, discussions within the Duma and government signaled that change was in the air, but it took almost six months for consensus to form on the joint CBR-government strategy that laid out a basic framework for bank reform. The strategy signaled a political shift, especially on the part of the government and the Presidential Administration, to raise banking reform from the B list of reforms to the A list. What was still missing, however, was a proactive force that could take operational responsibility for the bank reform program and to turn talk into action. Realistically this had to be the CBR. While the Ministry of Economy could push legislation in areas such as deposit insurance, CBR has always held the key to the pace and ultimate effectiveness of reform. What’s more, reforms shoved through by the government could actually be counterproductive if CBR did a poor job of implementing them (e.g. deposit insurance and moral hazard). Now, finally, with the new team at CBR, the final piece is in place. This week we look at how a new proactive CBR is likely to affect the pace of bank and other financial sector reforms.

<u>From foot dragger to driver</u>

There was a collective sigh of relief from all sides - reformers, the Duma, markets - when President Putin accepted Central Bank Chairman Gerachenko's resignation in mid-March. Simply removing him as an obstacle was seen as major progress. Still, few anticipated that a new team would replace him that could so quickly push the CBR from a barrier to an instigator of reform.

The new chairman, Sergey Ignatyev, and the new first deputies in charge of monetary policy and supervision (Oleg Vuygin and Andrey Kozlov, respectively) are known reformers, trusted by their former colleagues in the GOR. It is our understanding that Minister Gref, happy to get one set of reforms off of his Ministry’s over-full plate, has placed responsibility for bank reform squarely on the CBR’s shoulders. MinEcon and

MinFin will do what they need to do, especially in areas where they have formal responsibility such as deposit insurance, but CBR is to drive the process.

Preparing for action

The new CBR leadership has two main tasks: 1) clearly define its new policy program and 2) make organizational and personnel changes that allow them to be implemented. The former task is clearly easier, especially for Ignatiev who is not known as a strong organizational leader, and is apparently where the team will start. Several policy initiatives, we are told, are currently in preparation:

- On banking sector reform, a new program will focus on improving the efficiency and profitability of the banking system. This will complement, not replace, the existing strategy which focussed mostly on measures to stabilize the system. It is likely to be completed in the next month or two.

- On monetary policy, an agenda is taking shape to improve transparency and predictability, with improved coordination with the Ministry of Finance. Changes could include more active use of repo and lombard windows to provide liquidity to the system; lengthening terms on deposits to over three months to get more monetary stability; closer coordination with MinFin on domestic debt issuance; and possibly moving to a more explicit policy of targeting the monetary base or core inflation. The latter, if adopted and implemented, would put responsibility for sterilization more squarely on the fiscal side and eliminate much of the CBR's discretion in currency markets.

- On currency/capital controls, plans are being developed that would remove many inefficient and burdensome regulations – possibly including special S, N and K accounts. It will also clearly delineate regulators' responsibilities and discretion to reduce the scope for corruption. The new rules would be more liberal, though could stop short of eliminating the current 50% repatriation/surrender requirement. These changes would come in the form of a proposed new law on hard currency that would likely go to the Duma sometime in the fall.

Changing the Debate on Current Reform Measures

Beyond a new more active future agenda, the new team has refocused the debate on current issues. For example, privatization of Vneshtorgbank (VTB) is now moving along faster, with the recent CBR decision to sell all of its 99.9% stake to the government by the end of the year. (The previous Chairman had, under duress, agreed to give up 40% with the timing for sale unclear.) CBR clearly wants to rid itself of its conflict of interest in VTB, though at a price that approximates its R43B equity stake. Initial proposals from the government to provide long-term, low interest bonds don't meet this standard though they are like to be supported by the Duma who resent any transfer of budget funds to CBR. The question of price will be the key sticking point in passing a law to authorize VTB's transfer. Still, with more trust between CBR, GOR and Duma officials, this issue should be surmountable. There is a deadline: the amendments to law on the Central Bank will include an amendment requiring CBR to sell its shares to the government by the end of 2002 but also require that a special law be passed to do so.

The new CBR team is also making its mark on deposit insurance legislation with a more focussed approach to addressing moral hazard risks though tougher, more substantive eligibility standards. Under CBR's plan, banks taking private deposits would have to meet partially subjective measures of current and future financial position, business planning, internal procedures, and quality of management. Having to make judgements about real risk factors will likely come as a culture shock for CBR personnel used to simply making sure that every "i" is dotted and every "t" crossed. This will make deposit insurance the first big test of the new team's ability to fundamentally improve CBR's supervision by shifting to substance over form. A final decision on the government's deposit insurance draft should be taken in June with Duma passage targeted for the end of 2002.

Making it happen

All this seems for the good, but a crucial question remains. As noted, there is no one on the new CBR team with a clear proclivity for driving the kind of institution changes – replacing more top managers, downsizing, changing incentive structures – that are clearly needed for CBR to makes its policies stick. It may be that Ignatiev's initial caution is tactical. He wants to have a policy agenda in place to justify internal reforms. The new group also needs time to take stock of its organization. Still, unlike many GOR ministries, CBR cannot operate effectively with a few hard-working, competent leaders overseeing an intransigent, corrupt bureaucracy. To achieve their promise, the new CBR leaders will have to match their internal reforms to their external ones.

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. **STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The

index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.